G. IRC 501(c)(7) ORGANIZATION

1. Introduction

Social and recreational clubs were originally granted exemption in the Revenue Act of 1916. Congress stated that the reason for their exemption was that the experience of the Treasury Department had been that securing returns from clubs had been a source of expense and annoyance and had resulted in the collection of little or no tax. By contrast, the justifications offered by Congress for the majority of other exempt classifications are that they provide some sort of community service or public benefit.

Generally, social clubs are membership organizations primarily supported by funds paid by their members. The tax exemption of social clubs has the practical effect of allowing individuals to join together to provide themselves recreational or social facilities on a mutual basis, without further tax consequences, where the sources of income of the organization are limited to receipts from the membership. Thus, the individual member is in substantially the same position as if he had spent his income on pleasure or recreation without the intervening organization. (Note that IRC 277 provides that a membership organization not exempt from tax may deduct expenses attributable to the provision of goods, services, or insurance to members only to the extent of income derived from members. In any tax year in which deductions exceed income, excess deductions are treated as paid in the following year. The purpose of this provision is to prevent nonexempt membership organizations from effectively rendering themselves free of tax by offsetting losses from membership activities against income derived from investments or other nonmember sources to produce little or no taxable income. Were they permitted to do so, they could put themselves in a better position than exempt clubs, which are taxable on all income but so-called "exempt function" income. See IRC 512(a)(3) and 277. This provision could be significant in computing the tax due from a revoked club.)

2. General Rules

The ordinary meaning of the term "club" implies that there must be club members, and that there must be a "commingling" of the members for social, recreational, or similar purposes. The commingling requirement has been stated in Rev. Rul. 58-589, 1958-2 C.B. 266, Rev. Rul. 70-32, 1970-1 C.B. 132, and Rev.

Rul. 74-30, 1974-1 C.B. 137. Commingling is present if such things as meetings, gatherings and regular meeting FACILITIES ARE EVIDENT.

Rev. Rul. 58-589, 1958-2 C.B. 266, discusses the criteria for exemption under IRC 501(c)(7) and holds that a club must have an established membership of individuals, commingling, and fellowship to be a social club within the meaning of the statute. While this does not mean that a club cannot have artificial entities, such as corporations, as members, a federation composed completely of artificial entities (clubs) was held to be not exempt under IRC 501(c)(7) in Rev. Rul. 67-428, 1967-2 C.B. 204. The rationale of that case was that a federation of clubs was a collection of artificial entities not capable of the kind of commingling required of the membership of exempt clubs. Thus, corporate memberships will not automatically disqualify a club as long as there are sufficient individual members to provide the requisite amount of fellowship and commingling. (See Rev. Rul. 74-168, 1974-1 C.B. 139).

Clubs must be organized for pleasure, recreation and other non-profitable purposes. The Service has held that these other nonprofitable purposes must be similar to providing pleasure and recreation. Sponsoring activities of a noncommercial nature can lead to denial or revocation if the activities are not similar to providing pleasure and recreation. In Rev. Rul. 63-190, 1963-2 C.B. 212, an organization was held not to qualify for exemption under IRC 501(c)(7) where it provided its members with sick and death benefits.

A club is not exempt if it provides pleasure and recreation on a commercial basis. Evidence that a club may be operating on a commercial basis exists if:

1. Membership requirements are broad or vaguely stated;

2. The initiation charges or dues are so low that one-time or transient use of the facilities by the general public is encouraged;

3. Management is strenuously engaged in expanding club membership; or

4. Management can effectively perpetuate itself through close physical and financial ties to club activities or facilities, or by other means. (See Exempt Organizations Handbook IRM 7751-124.)

Reg. 1.501(c)(7)-1(b) makes it clear that making club facilities available to the public for a fee is not a permissible IRC 501(c)(7) activity, and it establishes a presumption that a club is engaging in business if the club solicits public use of its facilities. The basic problem in this area is to determine whether a substantial purpose of a purported club is to operate a commercial activity. This determination will necessarily rely on an examination of all relevant facts and circumstances.

3. P.L. 94-568

The tax treatment of social clubs has undergone a substantial change due to the passage of P.L. 94-568 on October 20, 1976. Prior to passage of this law, IRC 501(c)(7) provided exemption for clubs organized and operated exclusively for pleasure, recreation and other nonprofitable purposes. The law substitutes the word "substantially" for "exclusively". The law also added IRC 501(i) to the Code, which prohibits discrimination by certain social clubs. That section reads:

> (i) Prohibition of Discrimination by Certain Social Clubs. Notwithstanding subsection (a), an organization which is described in subsection (c)(7) shall not be exempt from taxation under subsection (a) for any taxable year if, at any time during such taxable year, the charter, bylaws, or other governing instrument, of such organization or any written policy statement of such organization contains a provision which provides for discrimination against any person on the basis of race, color or religion.

In addition, the law does not allow a social club exempt under IRC 501(c)(7) a corporate dividends-received deduction in computing unrelated business income tax, thus codifying longstanding service position in that regard.

4. Substitution of "Substantially All" for "Exclusively"

This change is most likely to cause problems in the interpretation of the law. The existing regulations under IRC 501(c)(7) are of no use in this regard and are being revised to reflect the provisions of the law.

Reg. 1.501(c)(7)-1(a) states, in part:

> In general, this exemption extends to social and recreation clubs which are supported solely by membership fees, dues, and assessments. However, a club otherwise entitled to exemption will not

be disqualified because it raises revenue from members through the use of club facilities or in connection with club activities.

The Service has attempted to clarify the kinds and degree of activities which would cause a club to lose its exemption through non-member participation in club affairs and activities (See Rev. Rul. 58-589, 1958-2 C.B. 266, which stated that dealings with non-members must be incidental to and in furtherance of general club purposes and the income from that participation must not inure to the benefit of the members.) Then, in Rev. Rul. 60-324, 1960-2 C.B. 173, an organization that derived 12 to 17 percent of its total income from the general public's use of its facilities was revoked as not being operated exclusively for pleasure, recreation or other nonprofitable purposes. Various court decisions also discussed the permissible volume of non-member income (See U.S. v. Fort Worth Club, 345 F.2d 52 (5th Cir. 1965)).

In Rev. Proc. 64-36, 1964-2 C.B. 962, the Service established guidelines for determining the effect on the club's exemption of gross receipts derived from non-member use of its facilities. The guidelines determined the extent to which these gross receipts would be taken into account as a factor reflecting the existence of a non-exempt purpose. These guidelines were superseded by Rev. Proc. 71-17, 1971-1 C.B. 683. The Service established as an audit guideline that if gross receipts derived from non-members exceeded $2,500 and were five percent or more of the total gross receipts of the organization a non-exempt purpose that could result in revocation was indicated. Gross receipts from non-members at or below these levels did not demonstrate a non-exempt purpose. Thus, a "safeharbor" rule was created. Even when the limits were exceeded, the Service looked at all the facts and circumstances to determine whether a non-exempt purpose existed. However, this audit standard related solely to the exempt status of a club, and had no effect on the amount subject to taxation as unrelated business income. (Income derived by a social club pursuant to a reciprocal agreement with a social club of like nature is to be treated as income from nonmembers, as the legislative history of this section indicates that it was intended that amounts derived from sources outside the membership are not entitled to the benefits of tax exemption. It should be noted that Rev. Proc. 64-36 provided that a social club would not be adversely affected by the presence of members of another social club under an agreement which provides for the reciprocal use of facilities. Rev. Proc. 71-17 did not address this issue because at the time of its publication this issue had not been resolved.)

Public Law 94-568 has changed the audit standard. Since the Tax Reform Act of 1969 subjected social clubs to tax on their investment income as well as

their unrelated business income, Congress felt that the percentage requirements could be liberalized as long as a club was substantially devoted to the personal, recreational or social benefit of its members. The Committee reports indicate their intent was to make it clear that social clubs may receive some outside income, including investment income, without losing their exempt status and permit them to derive a higher percentage of gross receipts from the use of their facilities and services by nonmembers than would have been permitted under published Service guidelines. The law allows organizations to receive up to 35 percent of their gross receipts, including investment income, from sources outside their membership without losing their exempt status. Within this 35 percent, not more than 15 percent of gross receipts should be non-member income. Gross receipts are defined in the Committee Reports for this purpose as:

> ...those receipts from normal and usual activities of the club (that is, those activities they had traditionally conducted) including charges, admissions, membership fees, dues, assessments, investment income (such as dividends, rents and similar receipts) and normal recurring capital gains on investments, but excluding initiation fees and capital contributions.

If the club earns more than is permitted under this law, a facts and circumstances test will be applied. Some facts and circumstances that may be considered are net profits derived from non-member use, the purpose for which a social club's facilities are made available to non-member groups, and the frequency of use of club facilities by non-members.

In the ongoing and protracted litigation involving Pittsburgh Press Club, (five decisions have been reported, three Federal district court opinions (two on remand) and two court of appeals opinions, and the case is currently being appealed on the basis of the lower court's findings of facts being clearly erroneous) the Service sought to revoke the club's exempt status on two bases. First, one class of members paid lower dues than other classes even though all classes had equal access to club facilities and services, resulting in inurement to the former class, and second, a substantial portion of its total gross receipts was from nonmember use of club facilities.

Despite a strong and obvious difference of opinion between the district court and the appellate court in this case, neither one has been willing to go so far as to sustain the Service's proposal to revoke on the basis of the facts available. Although the appellate court seems more disposed to that view, and has twice

sought to have the facts clarified, it has thus far found that (1) use of the club facilities by each membership class was roughly proportional to the dues charged that class, thus there was no inurement and; (2) revenues generated from non-member sources in the range of 11 to 17 percent of total gross receipts were not, as a matter of law, above the threshold of engaging in business and were not so high that, as a matter of law, exemption under IRC 501(c)(7) must be denied. The Court of Appeals has also stated that other factors should be considered, including the amount of net profits derived from nonmember use of club facilities and services, the purposes for which a social club's facilities are made available to non-member groups, and the frequency of use of club facilities made by non-members. When the percentage limitations of P.L. 94-568 are exceeded, these factors should be considered in the facts and circumstances test.

For the purposes of determining a club's net profits from nonmember use of its facilities and services, the Court of Appeals stated that it is proper to charge costs directly attributable to these activities (variable costs) against the income derived (such as cost of goods sold, salaries of employees while assigned to these activities, etc.). However, the Court stated that all fixed costs - those costs the club's members would have to bear in the absence of the nonmember income - such as rent, depreciation, utilities, maintenance, etc., could not be charged against nonmember income for this purpose. (The Court's reasoning may be found at 579 F.2d 751, 761.)

The Court did not expressly sanction this allocation method for any other purpose than determining net profits from nonmember income, and it must be emphasized that the concept of net profits from nonmember income is normally only relevant where a club derives over 15% of its gross receipts from nonmembers, which then requires an examination of all the relevant facts and circumstances.

The proper method of allocating expenses for the purpose of determining tax in cases involving dual use of facilities or personnel is stated in Reg. 1.512(a)-1. Expenses (both fixed and variable as those terms are used in Pittsburgh Press) should be allocated between the two uses on a reasonable basis. The Examination Guidelines Handbook (IRM 7(10)69 - Exhibit 700-1) contains an example of one method that we consider to be reasonable. This is merely an example and is not the only method that can be used.

5. Conduct of an Unrelated Business

The percentage guidelines and facts and circumstances tests apply only to nonmember use of club facilities. P.L. 94-568 does not allow a social club to include income from sources other than nonmember use of club facilities and investment income within the percentage guidelines, and was not intended to allow a club to engage in activities previously forbidden. While the law was intended to increase the allowance of nonmember income from club facilities, it was not meant to eliminate the prohibition against engaging in nontraditional business. The Committee reports state:

> It is not intended that these organizations should be permitted to receive, within the 15 or 35 percent allowances, income from the active conduct of businesses not traditionally carried on by these organizations.

The conduct of a business "not traditionally carried on" by social clubs should preclude exemption. An example of a business not traditionally carried on would be the sale of sporting goods to the general public from a location not physically attached to the club. This has all the characteristics of a business: solicitation of the general public, a recurring activity, and the conduct of an activity unrelated to the exempt function of a social club. Current thinking within the Service, although not yet finalized, is that the phrase "not traditionally carried on" means, in this context, not normally and usually engaged in by social clubs generally (as opposed to the particular club in question).

The Service has ruled that the sale of liquor to members for consumption off the club's premises does not constitute the raising of income from members through the use of the club's facilities and is neither related to nor in furtherance of a social club's exempt purpose. (See Rev. Rul. 68-535, 1968-2 C.B. 219). In the case of Santa Barbara Club v. Commissioner, 68 T.C. 200 (1977), that social club's exemption was revoked for the sale of liquor to members for off-premises consumption. These sales exceeded 25% of the club's total gross receipts and the gross profit derived from this service to members was in excess of 7% of the club's gross income from all sources. The court held that by conducting this activity to this degree, the club was not operated exclusively for exempt purposes.

6. Unusual Amounts of Income

The committee reports for P.L. 94-568 state that "where a club receives unusual amounts of income, such as from the sale of its clubhouse or similar facility, that income is not to be included in either the gross receipts of the club or

in the permitted 35 or 15 percent allowances." The problem in this area is to define "unusual amounts of income." The Service has allowed a club to sell property which it had obtained in furtherance of its exempt purpose without subjecting it to revocation. However, where an activity is recurring, or the club obtained property with the motive of generating a profit instead of furthering its exempt purposes, then it appears that the resulting income would not be the type of income Congress intended to exclude and would jeopardize the club's exempt status.

7. Discrimination

P.L. 94-568 inserted into the Code IRC 501(i), which provides that an organization exempt under IRC 501(c)(7) is to lose its exempt status for any taxable year if, at any time during that year, its governing instruments or written policy statements contain a provision that provides for discrimination against any person on the basis of race, color, or religion. It had been held in McGlotten v. Connally, 338 F. Supp. 448 (D.C., D.C. 1972), that discrimination on account of race is not prohibited under the Constitution in the case of exempt social clubs (although it is prohibited for 501(c)(8) fraternal lodges.) The Committee Reports note the McGlotten case and state:

> In view of national policy, it is believed that it is inappropriate for a social club or similar organization described in section 501(c)(7) to be exempt from income taxation if its written policy is to discriminate on account of race, color or religion.

No mention is made in the Committee reports as to the treatment of ethnic clubs and cases involving this issue should be sent to the National Office for resolution as per Manual Transmittal 7(10)G-40 dated March 30, 1979.

It should be noted that certain auxiliaries of fraternal beneficiary societies such as the Knights of Columbus have been properly classified as social clubs. Some may have written provisions in their governing instruments limiting membership to individuals of a particular religion, thus violating the provisions of IRC 501(i). H.R. 5505, a proposed bill currently pending in Congress, would allow these organizations to maintain their discriminatory provisions without consequence, if the fraternal beneficiary society is exempt under IRC 501(c)(8).

8. Dividends Received Deduction

The major reason for the dividends received deduction in IRC 243 is to avoid so-called "double taxation" in corporate taxes on earnings as income is passed from one corporation to another. Income on which the corporation has paid a tax is then taxed to individual shareholders when the earnings are paid out as dividends to them. In the case of social clubs, certain fraternities and sororities and employees beneficiary associations, the tax on shareholders does not apply since the dividend income received by these organizations is not distributed to the members although they reap the benefits in reduced dues or increased services. Since the exempt organization is in effect taking the place of the individual member for tax purposes, the tax applies to these organizations in the same manner as in the case of individual shareholders. The law amends IRC 512(a)(3) (and 277) to provide that the corporate dividends received deduction is not available to exempt clubs in the case of their investment income from corporate dividends, thus making this income taxable as unrelated business income. This was intended as a clarification of existing law, not to imply that such dividends were excludable under previous interpretations.

9. Effective Date

The specified effective date for P.L. 94-568 is for years beginning after October 20, 1976. However, the Committee reports indicate that the changes made as to income from nonmembers and investment sources were intended as a clarification of existing law under the Tax Reform Act of 1969. Despite this language, Treasury has decided that P.L. 94-568 will not be given retroactive effect, as the effective date contained in the statute is not ambiguous and thus governs.